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IN THE

Supreme Court of the United States

OCTOBER TERM, 1968

No. 780

THE FRANKLIN LIFE INSURANCE COMPANY, Petitioner,

v.

UNITED STATES OF AMERICA, *Respondent.*

BRIEF AMICUS CURIAE OF AMERICAN LIFE CONVENTION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

FRED C. SCRIBNER, JR.
THOMAS C. THOMPSON, JR.
1200 18th Street, N.W.
Washington, D. C. 20036
Attorneys for
Amicus Curiae

Of Counsel:

SCRIBNER, HALL, CASEY,
THORNBURG & THOMPSON
1200 18th Street, N.W.
Washington, D. C. 20036

PIERCE, ATWOOD, SCRIBNER,
ALLEN & MCKUSICK
465 Congress Street
Portland, Maine 04111

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Statement of Interest of the Amicus

The American Life Convention, filing this brief amicus curiae, is a nonprofit voluntary trade association organized in 1906. It is the oldest international association of life insurance companies. Its membership comprises 350 legal reserve life insurance companies located in 45 states, the District of Columbia, and three provinces of Canada. These companies represent 91 per cent of the legal reserve life insurance

in force in the United States and Canada. The organization deals with problems affecting the interests of legal reserve life insurance companies and their policyholders.

This case involves the construction of the Internal Revenue Code, as amended by the Life Insurance Company Income Tax Act of 1959 (Pub. L. No. 86-69, 73 Stat. 112; Sections 801-820, Internal Revenue Code of 1954, as amended), such Act being hereinafter referred to as the 1959 Act. The 1959 Act for the first time since 1921 taxes life insurance companies on the basis of an annual determination of income from all sources. The decision in this case is the first decision under the 1959 Act by a United States Court of Appeals construing the methods of accounting to be followed by a life insurance company in computing its annual income subject to Federal income tax.

The 1959 Act added Section 818(a) to the Internal Revenue Code of 1954, which Section required life insurance companies to follow an accrual method of accounting. The United States Court of Appeals for the Seventh Circuit held that Petitioner was required to include in income the gross amount of deferred and uncollected premiums, an expectancy of income which it had not received and had no right to receive. This holding is in conflict with principles of tax accrual accounting prescribed by this Court for other taxpayers. The Court also held that petitioner was required to include in income advance interest which had not been earned, contrary to the tax treatment accorded other financial institutions.

The issues thus considered by the Court of Appeals affect significantly the Federal income tax computa-

tion of almost every life insurance company, most of whose tax returns are "open" for the years after 1957, the effective date of the 1959 Act. Large aggregate amounts of liability are involved.[1] It may be expected that the present differences between the Internal Revenue Service (hereinafter "IRS") positions and those of life insurance company taxpayers will remain unsettled until this Court resolves them. In the meantime, the uncertainty of the ultimate outcome of these issues is crippling the orderly administration of the Federal income tax laws for the life insurance industry. The Amicus, accordingly, submits this brief amicus curiae in support of the Petition for a Writ of Certiorari in the *Franklin Life* case and urges that the Writ be granted for the reasons set forth below.

The consent of the parties to the filing of this brief amicus curiae has been filed with the Clerk of the Court.

Opinions Below, Jurisdiction and the Statutes Involved

The Amicus respectfully refers the Court to the Petition for the statement of the Opinions Below, Jurisdiction, and Statutes Involved.

Questions Presented

1. Under the accrual method of accounting provided by the 1959 Act, must a life insurance company include in income in a year prior to its receipt—and treat as an asset—an amount of deferred and uncollected premiums which the company has no legal right to collect?

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[1] Petition 25, 26.

2. Must a life insurance company, unlike other financial institutions, include in income advance interest prior to the year it is earned; and report as an asset the amount of capitalized interest which is neither received nor earned?

Statement

The Amicus respectfully refers the Court, for a full statement of the issues presented, to the Petition and here indicates only sufficient detail for clarity of its brief argument.

1. *Premiums Deferred and Uncollected*—Life insurance premiums and the related reserves, as a consequence of mortality tables presented in yearly increments of death, are calculated by Petitioner on a policy-year basis. Premiums are charged to policy owners in most cases, however, on a quarterly or more frequent basis. At the end of each taxable year the life insurance company, therefore, has in force insurance policies with fractional premiums which are not "due" until the subsequent year, as well as policies with premiums "due" and unpaid but within the grace period. All such premiums are payable at the election of policy owners and the insurance company has no right to have them paid. These two classes of premiums constitute Petitioner's "premiums deferred and uncollected".

The Court of Appeals adopted the IRS position, reversing the District Court, and held that the gross amount of deferred and uncollected premiums must be included in income. The Petitioner's books of account, as presented in its "Annual Statements" in accordance with applicable State regulations, include the

increase in reserves related to premiums deferred and uncollected as a debit item and simply cancel the effect of including this debit item by offsetting against it the net valuation premium with respect to premiums deferred and uncollected. This "net valuation premium" is in an amount which exactly offsets the reserve increase which relates to the premiums deferred and uncollected. The subtractive difference between this net valuation premium and the gross amount of premiums deferred and uncollected is termed the "loading" thereon. As set forth in the Petition (see note 10, page 9), it is really the "loading" on the premiums deferred and uncollected which is in issue as to this point.

Further, the Court of Appeals adopted the IRS position, reversing the District Court, and held that the amount of such "loading" at year end should be included in the valuation of assets for purposes of the investment income formula of the 1959 Act. The Court's opinion failed to deal expressly with the relevant Code Section (805(b)), which requires the amount of any asset valued in the investment income formula (other than real property and stock) to be its cost basis for tax purposes.

2. *Unearned Interest*—Life insurance companies, in making loans on the security of the cash value of policies, may receive each year's interest in advance or may capitalize a year's interest by adding it to the principal of a loan when made. If a policyholder repays the loan before the end of a year for which interest was received or capitalized, the life insurance company credits him with a pro rata share of interest representing the unearned amount. The IRS required inclusion in income of advance policy loan interest not yet earned; and also required that amounts not received

or earned, but capitalized, should be included in the valuation of assets.

The Court of Appeals reversed the District Court in an opinion concurring with the IRS position on each point. The Court of Appeals held that the IRS was free to reject the deferral of unearned items in order to "clearly reflect income" under Section 446(b) of the Internal Revenue Code. This conclusion was applied to the valuation as an asset of interest not prepaid but capitalized.

Reasons Why the Amicus Believes the Writ Should Be Granted

1. In *Schlude* v. *Commissioner,* 372 U.S. 128 (1963), this Court remanded with instructions to permit deferral by an accrual-method taxpayer of precisely the form of future income expectancy in question here: amounts which are neither earned, due nor received.[2] If under the *Schlude* decision the increase in loading

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[2] In *Schlude* v. *Commissioner,* taxpayers operated a studio offering dancing lessons under contracts providing for a cash down payment with the balance payable in installments or by a negotiable note. The contracts, which called for a specified number of lessons without a specification of the dates, were non-cancellable and the student would not be relieved of the obligation to pay the balance due on the contract nor would any refunds be made. At year end, taxpayers analyzed the contracts and brought into income only the amount attributable to lessons actually given, the balance of the contract amounts being deferred until a subsequent year.

The Tax Court, 32 T.C. 1271 (1959), and the Court of Appeals, 296 F.2d 721 (8th Cir. 1961), held that the taxpayer must include in income all contracts entered into during the taxable year. In this Court, however, the Commissioner conceded with respect to accruing amounts that were "neither due as a matter of contract, nor matured by performance of the related services." See 372 U.S. 128, 133 n.6 (1963). On the basis of this concession this Court reversed the part of the judgment below which accrued "amounts for which services had not yet been performed and which were not due and payable. . . ." 372 U.S. at 137.

on deferred and uncollected premiums is not properly includible in the income of a life insurance company for the year past, then clearly the loading at year end is not an asset. Even if considered an asset, it has no cost basis for tax purposes, the required standard of valuation under Code Section 805(b), since it is not includible in income.

The Petitioner here seeks no more than to follow its own books of account, which were found in this respect clearly to reflect income. Petitioner's Annual Statements were prepared in the manner prescribed by the National Association of Insurance Commissioners ("N.A.I.C.") and, as the Amicus argued below, Section 818(a) of the 1959 Act declares that manner of accounting to be the accrual method appropriate for computation of taxes by the life insurance industry.[3] However, even if Section 818(a) of the 1959 Act did not contain a reference to the N.A.I.C. method of ac-

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[3] With respect to deferred and uncollected premiums, the District Court found the N.A.I.C. method to be as follows:

> "The reserve liability of the Plaintiff, as required by law, is determined at the end of the calendar year and this item of reserve is shown on Line 1 of Page 3 of its Annual Statement as a liability. Included in this liability item are the deferred and uncollected net annual valuation premiums for which the Plaintiff has not received an offsetting item of income. The method of accounting prescribed by the National Association of Insurance Commissioners provides for the offsetting of the deferred and uncollected premiums by the inclusion of the deferred and uncollected premiums in the premium income of the plaintiff. Only net deferred and uncollected premiums are needed as offsets for the net annual valuation portion of the premiums included in reserves and the inclusion of the gross deferred and uncollected premiums overstates the premium income of the plaintiff. The Annual Statement required of the plaintiff provides a method of offsetting the overstatement of unreceived income." (Petition, Appendix D, 33a-34a.)

counting, the opinion of the Court of Appeals would deny, to the accrual-method life insurance companies, deferral of income recognition which under the same circumstances would be permitted to other accrual-method taxpayers.

2. Banks and other accrual-basis lenders report interest as income ratably over the period of the loan. The reason for this long-established rule is that interest is earned day by day. (See Banking Law Journal, *Federal Income Taxation of Banks and Other Financial Institutions* (1968) ¶ 5.03(a); see also Prentice-Hall, *Federal Taxes* (1968) ¶ 7215(30), citing S.M. 3820, IV-2 Cum. Bull. 32 (1925) and *Madison & Kedzie State Bank,* 1 B.T.A. 922 (1925).) The holding of the Court of Appeals, if let stand, would accelerate the reporting of insurance company interest income to an earlier period than that required of other financial institutions.

The Court of Appeals held, without explanation, that the capitalized amount of such interest should be included in the valuation of assets. Section 805(b) of the 1959 Act requires insurance company assets, regardless of book value, to be valued at their tax basis. There being no actual cost to the company of unearned interest, as an item which has not been recognized in income following Petitioner's contention, unearned interest must receive a zero basis.

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[4] The holding of the Court of Appeals for the Seventh Circuit as to advance interest on insurance policy loans, which applied a "claim of right" rule to capitalized interest despite a strict obligation to credit interest on repayment, contrasts sharply with the same court's holding as to advance ticket receipts and broadcast revenues by a baseball club with a fixed game schedule. See *Artnell Co.* v. *Commissioner,* 7th Cir., September 19, 1968, 68-2 U.S.T.C. ¶ 9593.

The Importance of Review

The Amicus has circulated among its membership a questionnaire, the results of which are presented in the Petition, clearly showing the litigation-breeding character of the issues in this case. Large aggregate amounts of income—and therefore considerable income tax—are now in doubt for each of the years from 1957 to the present.[5] The issues in this case will produce uncertainty in reporting and auditing for future tax years.

As explained in the Petition, life insurance companies and the IRS have disagreed in their positions on these issues since shortly after passage of the 1959 Act. Litigation of these issues will in all likelihood continue until this Court definitively resolves them. Orderly administration, including the expeditious closing of many tax years now "open" and predictable reporting and payment of taxes for future years, will be assisted by grant of the Writ in this case. The persistence of the IRS and taxpayers in maintaining their respective positions since 1961 makes it clear that no lower forum can settle the issues now raised here.[6]

Conclusion

The Court of Appeals for the Seventh Circuit reached results on both branches of this case which were unwarranted by the 1959 Act. As to both unearned interest and premiums deferred and uncollected, the principles from which the Court departed are, as indicated above, essentially simple ones.

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[5] See Petition 20-28.

[6] See also Petition 26-28, 32-36.

If the decision of the Court below is let stand, the well established and readily followed principles of income accrual and deferral will not be applied to life insurance company taxpayers on the same basis as to other taxpayers. Moreover, there will be included in the assets of life insurance company taxpayers amounts which are not, under those settled principles, to be included in the year-end valuation of assets by the tax-cost standard of the 1959 Act. The importance of these issues to the entire life insurance industry—and the orderly administration of the Federal tax laws applicable to the industry—strongly recommend that this Court take the opportunity to review this case.

For the foregoing reasons, the American Life Convention supports the position of the Petitioner and urges that a Writ of Certiorari be granted.

Respectfully submitted,

FRED C. SCRIBNER, JR.
THOMAS C. THOMPSON, JR.
1200 18th Street, N.W.
Washington, D. C. 20036
Attorneys for
Amicus Curiae

Of Counsel:

SCRIBNER, HALL, CASEY,
THORNBURG & THOMPSON
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